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LOS ANGELES BAR BULLETIN



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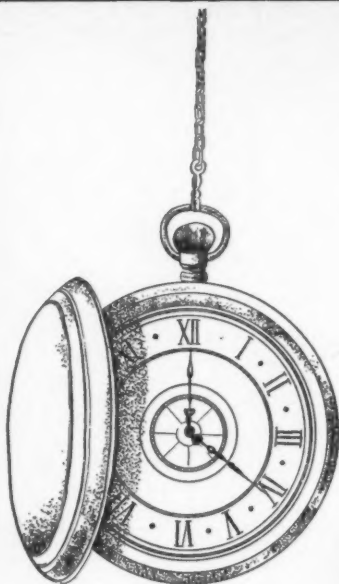
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VOL. 29

DECEMBER, 1953

No. 3



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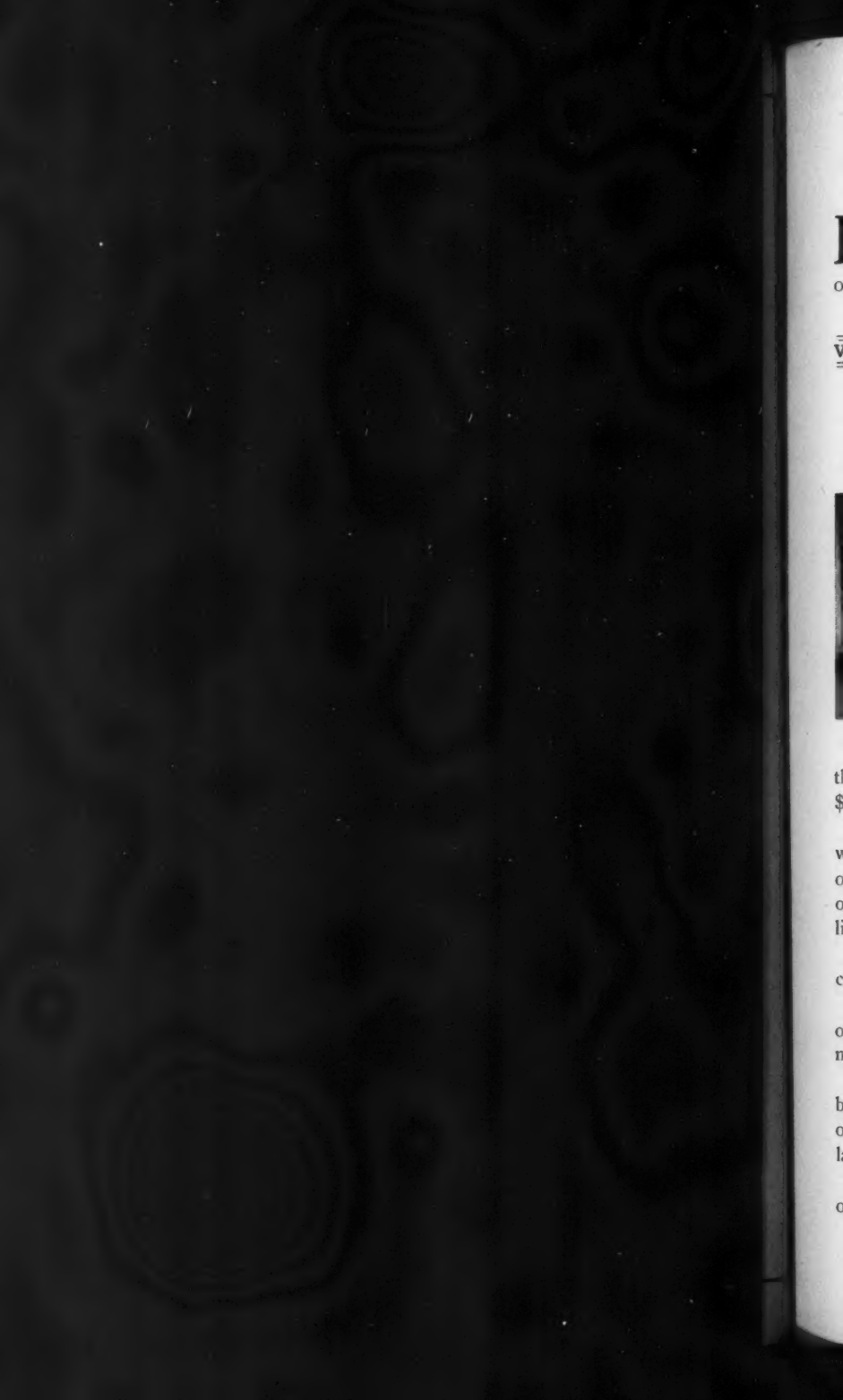
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Los Angeles BAR BULLETIN

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VOL. 29

DECEMBER, 1953

No. 3

President's Page

By W. I. Gilbert, Jr.
President, Los Angeles Bar Association



W. I. Gilbert, Jr.

Because of its interest and importance, the message given by Mr. James C. Shepard, at the luncheon meeting of the Los Angeles Bar Association on November 19, 1953, is set forth in full:

"Your American Bar Association, 50,000 strong, is the national voice of our profession. Its present headquarters is an old Chicago house, shoddy, and completely inadequate. So important is the need of the association for a national center, that the University of Chicago has given land valued in excess of \$500,000, on which the American Bar Center is being built.

"The cost of building this center, and starting its initial work, will be approximately \$2,000,000. Five Hundred Thousand Dollars of this sum has been contributed by specific bequests, \$400,000 of which was bequeathed by the will of that eminent lawyer, William Nelson Cromwell, of New York.

"Therefore, the total sum which we are asking from all American lawyers is \$1,500,000.

"The American Medical Association, almost every labor union of which you think, almost every business organization has adequate national headquarters. The American Bar needs a national home.

"In this home, when built, research is already under way embracing more than 50 subjects of current interest to all members of our profession, which will benefit every present and future lawyer in America.

"The Southern California territory has a quota for this purpose of approximately \$63,000.00. In this territory there are 1,707 mem-

bers of the American Bar Association. This means that if each lawyer in Southern California would pledge the sum of \$60.00 per lawyer, to the American Bar Foundation, payable in equal installments over a three year period, we would exceed our quota.

"I am urging you to contribute to this cause.

"Your contributions, by a formal ruling of the Bureau of Internal Revenue, are deductible for federal income tax purposes; your payments may be spread over three years; and participation by every member of the Bar of Southern California will be helpful, whether or not you are a member of the American Bar Association.

"As a member of the profession, irrespective of membership, you participate in the benefits from the organized work of the Bar.

"The cornerstone of the American Bar Center was laid on November 2, 1953. It was my great privilege to witness this ceremony, and Mr. Associate Justice Robert H. Jackson, in a challenging address, said as follows:

'Cornerstones are commonplace unless they gain distinction from the vision and faith of those who lay them. Our vision today is of an American Bar Center which will focus the influence and pilot the activities of the largest association of lawyers in the world. This influence literally saturates American intellectual life. Generally, in each community its members are among the most respected and articulate leaders in every field of thought and action.

'The special competence and responsibility of the bar is in the administration of justice under law, because the private law office is the very cornerstone of that system. Only through it can the citizen learn the increasingly complicated rules which bear upon his peculiar rights or obtain effective access to any except minor courts. To these offices each day come countless men and women in grief or greed, in anger or distress.' * * *

'What are we doing today? We are building a cathedral to testify to our faith in the rule of law.'

"Will you not, therefore, make your contribution and pledge to the American Bar Foundation, thus testifying tangibly to your faith in the leading organization in America which seeks to perpetuate rule of law in a world where that rule is contesting with rule by man.

"Make your checks payable to the American Bar Foundation, and send them to Loyd Wright, Suite 1125, 111 West Seventh Street, Los Angeles 14."

Your Tax Return — Reporting Income From Your Profession

Prepared under the auspices and at the request of the Committee
on Taxation of the Los Angeles Bar Association.

By William Halpern*

The scope of this article is limited to reporting your income from your law practice in preparing your Federal income tax return. It deals principally with the items to be reported upon Schedule C which accompanies your return, Form 1040. It is further necessarily limited by considerations of space and by the selection of matters that are of general interest as distinguished from problems arising from facts that are applicable only in particular instances. A subsequent article will deal with items of personal income and personal deductions.

The most convenient sources for further information regarding the preparation of your tax return are as follows: Internal Revenue Code (IRC), Regulations 118; Prentice Hall 1953 Federal Tax Service (P-H); and Commerce Clearing House 1953 Standard Federal Tax Reporter (CCH).

A. METHOD OF ACCOUNTING:

IRC Section 41, and Regulations 118, Section 39.41, contain the requirements respecting methods of accounting. The two most common methods are (1) the cash method, and (2) the accrual method.

Although under the cash method you record your income only when you receive it, you may be required to report income not yet actually received on the ground that it has been constructively received. Generally you have constructively received income when (1) you are legally entitled to receive the same, and (2) the debtor has the money and is willing to pay you, and (3) all you have to do to receive the money is, to use a figure of speech, hold out your palm. As to expenses and other deductions, however, no corresponding principle of constructive payment exists.

*College of William and Mary, 1930. Private practice, Beverly Hills. Author of several articles on taxation. Lecturer, S.C. Tax Institute and State Bar Continued Education Program. Admitted to Virginia and California Bars.

Generally the cash method is best suited to an attorney. This method does not require you to pay taxes upon your income until you have received such income, even though you have already earned it. Some attorneys, however, although using the cash method, record all their fees in their books when earned, whether or not the same has been collected, and at the close of the year an entry is made upon such books eliminating the then uncollected fees. If you resort to this practice, it may give rise to a serious problem. The Bureau might contend that you are using a hybrid method of accounting during the year, that you are at the close of the year departing from such hybrid method and, as a consequence, that you are making your return upon a method of accounting different from that employed in keeping your books. It is suggested that the problem be avoided by simply having a fees register in which you enter fees when earned, and payments when collected. In your books of account, however, you will record the fees only when collected.

B. INCOME:

(a) Generally.

IRC Sec. 22(a) is the basic provision defining taxable income. It is extremely broad in its scope. Further interpretation of this section may be found in Reg. 39.22(a); P-H, Par. 7102, *et seq.*; CCH Par. 55, *et seq.*; and in the instructions which accompany the income tax return (Form 1040).

(b) Compensation Received in Kind.

IRC Sec. 22(a) requires the inclusion of "income derived from . . . (professions) . . . of whatever kind and in whatever form paid . . ."

Thus, even though you are on the cash basis, you must report as income, upon the receipt thereof, the fair market value of any property conveyed to you as compensation for services rendered. Not infrequently, when you receive compensation in kind, the property conveyed to you consists of either an interest in real estate or the capital stock of a corporation. Generally, upon a subsequent sale of either of these properties, the gain will be a capital gain. Inasmuch as you are required to report as ordinary income (compensation for services) the fair market value of the property when received by you, such fair market value becomes your cost basis for the purpose of determining the gain upon such subsequent sale. Hence, your capital gain will be the excess of the proceeds

(Continued on page 81)

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Irrevocable Trusts for Children of Trustor

By Joseph H. Rose*



Jos. H. Rose

In view of high income taxes, both present and prospective, the matter of reduction of such taxes through the medium of trusts is of importance. A typical situation is that of the trustor who wishes to reduce his income and estate tax by setting aside funds for the benefit of his minor or adult children. The following is a brief summary of the income tax, estate tax and gift tax rules relating to such trusts:

INCOME TAXES

This situation falls squarely within the rule of *Helvering v. Clifford*, 309 U. S. 331 (1940) and Reg. 111, Sec. 22(a)—21 & 22. In brief, the Regulations provide that a trustor must pay the income tax upon trust income although he has no right to receive it if he has (i) the power to determine or control beneficial enjoyment of income or corpus; (ii) a reversionary interest after a relatively short period; or, (iii) administrative control. In addition, note that, as mentioned under IV, *infra*, a trustor will also have to pay the tax on trust income where the trustee uses the income for support and maintenance of trustor's dependents.¹ These points will be considered in the order named.

I. Power to Control Beneficial Enjoyment of Income or Corpus.

In general it may be said that if a trustor can control the beneficial enjoyment of the income or corpus, whether by revocation, alteration, or otherwise, exercisable by him or another person lacking a substantial adverse interest in such disposition, or by both, the income is taxable to the trustor. This is true irrespective of the duration of the trust.

There follows a list of powers which, if reserved by the grantor (trustor), will subject him to income tax, and a list of powers which he may retain without subjecting himself to an income tax on trust income. They purport to be typical, and cover most situations. It will be noted that certain powers may safely be conferred on an independent corporate fiduciary, which could not be conferred on the trustor if he were trustee.

*Of the Los Angeles Bar; LL.B. Harvard University 1927; Trust Counsel, Security-First National Bank of Los Angeles.

¹Sec. 167(c) I.R.C.

A. Taxable Powers

1. The power to change the beneficiaries whether reserved to grantor individually or as trustee, with minor exceptions.
2. The power to invade income for support of a minor-child-remainderman during such child's minority. If none of the income is so used the grantor is not taxable under Section 167(c) of the Code, because the income was not used for the child's support, but he is taxable under the Clifford Regulations because of the power.
3. The power to accumulate income and appoint it by will. A corporate trustee may be given this power to accumulate and add to corpus, however, without subjecting the grantor to the income tax. A close relative or employee does not qualify. For precise dividing lines between "independent" and "controlled" trustees, see the very careful language of the Regulations. The grantor's brother and attorney as co-trustees would seem to qualify for the immunity.
4. The unlimited power to invade corpus for the beneficiaries. This is tantamount to a power to change beneficiaries. A corporate trustee may be given this power, however, without rendering the grantor taxable. The grantor's brother may be made a co-trustee with veto power over the corporate trustee without loss of immunity to the grantor.
5. The power to accumulate income for distribution to any persons other than those who would ultimately have received it, or their estates.

B. Non-Taxable Powers

1. The power to change the remainder interest if the grantor would not have been taxable on the income if he had owned the interest in reversion. (*Example:* Income to the grantor's wife for life, remainder to his daughter. The grantor reserves power to transfer the remainder to his son. He is not taxable on the income since he would not have been taxable if he had retained the reversion after the wife's life estate.)
2. The power to change the income beneficiaries after the expiration of a period of ten years. The grantor is not taxable during the ten-year period.
3. The power to substitute another charity for the one set forth in the trust instrument.
4. The power to invade corpus for the beneficiaries if limited by a "reasonably definite external standard." Illness would be a suffi-

(Continued on page 93)

Scanning Recent Legislation*

This article was commenced in the Junior Barristers' issue of the Los Angeles Bar Bulletin (September, 1953). Its purpose is to comment on some of the significant changes effected by the 1953 California Legislature. This portion of the article is concerned with enactments included within Chapter Laws 1100 to 1895.

CODE OF CIVIL PROCEDURE

Blood Test to Determine Paternity

By the addition of Sections 1980.1 to 1980.7 to the Code of Civil Procedure, part of the uniform act concerning the use of blood tests to determine paternity has been enacted. As enacted, the statute provides in part: (1) if any party refuses to submit to blood tests, the court may find against the party on the question of paternity, and (2) if the court finds that all of the experts employed conclude lack of paternity, then the question must be resolved accordingly. Provisions of the uniform act regarding the effect of a positive finding, and the effect of the act upon the presumption of legitimacy of a child born in wedlock, have not been enacted. It is further provided that, within certain limitations, the act applies to criminal cases (Ch. 1426).

Peremptory Challenges to Jurors

Section 601 of the Code of Civil Procedure has been amended to provide expressly that a side may pass a peremptory challenge without diminishing the number of its remaining peremptory challenges. Section 601 also has been amended to provide expressly that if both sides pass a peremptory challenge consecutively, the jury shall then be sworn unless the court for good cause orders otherwise (Ch. 1578). (Section 1088 of the Penal Code has been amended in a similar manner. Ch. 1585.)

Payment of Taxes in a Condemnation Action

Section 1252.1 has been added to the Code of Civil Procedure to provide, in an action in which a tax exempt public agency is the plaintiff, a procedure for payment out of the condemnation award of all taxes due on property being con-

*This article was organized and edited by a committee composed of Wendell B. Will, Roger Williams and William L. Scott, and is due largely to the efforts of the following members of the Bar: James S. Cline, Gilbert E. Haakh, William C. Hiscock, Donald R. Hodgman, Roy E. Potts and E. Harley Walther.

demned. This new section also provides that the subject of the amount of such taxes shall not be relevant on any issue in the condemnation action. Any mention of the subject, either in the voir dire examination of jurors, during the examination of witnesses, as a part of the court's instructions to the jury, in argument of counsel, or otherwise, constitutes grounds for a mistrial (Ch. 1792).

Proof of Service by Mail

Section 1013(a) of the Code of Civil Procedure has been amended to provide that service by mail and proof thereof may be made by a person either resident or employed in the county where the mailing occurred (Ch. 1110). Previously, mere employment was insufficient.

Statute of Limitations

By amendments to Sections 336 and 337.5 of the Code of Civil Procedure, the period prescribed for the commencement of an action upon a judgment or decree of any court of the United States, or of any state within the United States, has been extended from five to ten years (Ch. 1153).

Uniform Reciprocal Enforcement of Support Act

By amendments and additions to Sections 1650 to 1690 of the Code of Civil Procedure, the "Uniform Reciprocal Enforcement of Support Act" has been substituted for the "Reciprocal Enforcement of Support Law." These new sections are almost identical to the uniform act as amended in 1952 by the National Conference of Commissioners on Uniform State Laws (Ch. 1290).

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CIVIL CODE

Fixtures

By the addition of Section 1013.5 to the Civil Code, any person acting in good faith who affixes improvements to the land of another, under the erroneous belief that he has a right to do so, shall have the right to remove such improvements upon payment of damages (Ch. 1175).

Term of Mineral Lease

Section 718f has been added to the Civil Code permitting a mineral lease to be made for a period certain or determinable by any future event but limiting the period of enforcement of such leases to a maximum term of 99 years (Ch. 1344).

Definition of Minors

By amendment of Section 25 of the Civil Code, a lawfully married female who has reached the age of eighteen is deemed to be an adult for the purpose of maintaining or defending an action affecting her marital status (Ch. 1128).

Adoption of Minors

Sections 221 and 227(p) of the Civil Code have been amended to require the consent of the spouse of a married minor child before such child may be adopted (Ch. 1220).

It is now made clear by an amendment to Section 226 of the Civil Code, that a minor parent's consent to the adoption of his child is not revocable because of such minority (Ch. 1220).

PROBATE CODE

Filing of Creditors' Claims

Section 702 of the Probate Code formerly provided that the time for filing Creditors' Claims is extended for the period delayed in not filing the affidavit of publication of notice to creditors. This section has been amended to limit such extension to six months after filing the affidavit (Ch. 1179).

Family Allowance

Section 680 of the Probate Code has been amended to include within the class entitled to a family allowance those adult children judicially declared incompetent (Ch. 1215).

Payment to Parent of Minor without Guardianship

Section 1430 of the Probate Code has been amended to permit payment of \$1000 (formerly \$500) to the parent of a

minor providing the minor's estate does not exceed \$2500 (formerly \$1000) (Ch. 1237).

Sales on Credit

Probate Code Sections 787 and 1532 have been amended to permit the taking of second liens in sales by decedent or guardianship estates subject to approval of the court (Chs. 1238, 1239).

CORPORATIONS CODE

Articles of Incorporation

Several sections of the Corporations Code dealing with requirements for articles of incorporation have been changed in a lengthy amendment. Sections 3670 and 3672, dealing with the necessity for the execution and filing of a certificate of amendment of articles, and the content of such certificates, have been reworded and made applicable to non-profit corporations. Section 9304.5 is added to provide for the filing of articles of a non-profit corporation with the Secretary of State, and in the office of the County Clerk of the County in which the corporation has its principal office, and in the office of the County Clerk of each County in which the corporation acquires ownership of any real property. (These sections correspond to Sections 308, 311 and 312 of the Corporations Code relating to profit corporations.) It is also provided, by amendment to Section 9302, that either the articles or the by-laws of a non-profit corporation may specify the manner in which directors can be removed from office (Ch. 1126).

Mortgage or Sale of Assets

As a result of an amendment to Section 3904 of the Corporations Code, the certification of instruments conveying corporate assets are now evidence of the facts authorizing such conveyance although less than substantially all of the assets are conveyed (Ch. 1301).

Abandoned Property

As a result of an amendment to Section 5010 and the repeal of Section 5011 of the Corporations Code, distribution of unclaimed property of a dissolved corporation, which is deposited with the State's Treasurer or a bank or trust company in California, is governed by the general rules for the distribution of

abandoned property set forth in Sections 1460 et seq. of the Code of Civil Procedure (Ch. 1686).

LABOR CODE
(Workmen's Compensation)
Medical Examinations

Section 122.1 has been added to the Labor Code to permit the Industrial Accident Commission to appoint doctors to make medical examinations. The cost of such examinations is to be borne by the Commission (Ch. 1858).

Commission Procedure

Sections 5313, 5315, 5800.5 and 5908.5 of the Labor Code have been amended to provide for slightly different procedures for the Industrial Accident Commission. Commission decisions are to be rendered within thirty days after the case is submitted instead of after testimony is closed. Separate findings of fact and conclusions of law are no longer required, and as a substitute, there is to be served a summary of the evidence received and relied upon and the reasons or grounds of determination. Decisions rendered on petitions for reconsideration have been similarly treated (Ch. 1256).

Insurance Carriers

By the addition of Section 11661.5 to the Labor Code, an insurer can not insure against employer liability for injuries sustained by illegally employed persons under sixteen years of age (similar to the case of serious and wilful misconduct by an employer) (Ch. 1255).

PENAL CODE
Right to Counsel at Hearing

Section 866.5 has been added to the Penal Code providing that a defendant may not be examined at a magistrate's hearing unless he is represented by counsel or unless he waives this right after being so advised (Ch. 1482).

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Silver Memories

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A. Stevens Halsted, Jr.

Thirteen of the Los Angeles Bar Association's charter members are still active members after 40 years, according to **T. W. Robinson** of the Board of Trustees. The list includes **Albert M. Stephens**, **J. A. Anderson, Jr.**, **Lucien Shaw**, **C. W. Pendleton**, **Frank Finlayson**, **R. F. Del Valle**, **J. A. Graves** and **Henry O'Melveny**. Other members since 1888 are **N. P. Conrey**, **J. W. Swanwick**, **Shirley C. Ward**, **Robert N. Bulla** and **George J. Denis**. The organization started with 50 charter members. Most of the 13 survivors, after 40 Los Angeles summers, are still very much on the active list.

* * *

Fainting as the black cap was adjusted, **William Edward Hickman**, 20, was hanged at San Quentin Prison for the murder last December of **Marian Parker**, 12 year old Los Angeles school girl.

* * *

Governor **C. C. Young** has appointed **H. L. Carnahan** as the new Lieutenant-Governor to succeed **Buron Fitts** who resigned after being elected District Attorney of Los Angeles County in the August primaries. Carnahan was the first Corporation Commissioner of this State, serving from 1914 to 1918.

* * *

The Pasadena Bar Association is acting as host for the State Bar Convention. **J. W. Morin** is in charge of arrangements, assisted by **Raymond Thompson**, **Herbert Hahn**, **Douglas Fisher** and Judge **Elliot Gibbs**.

General **Chiang Kai-shek**, commander-in-chief of the Nanking military forces in the Nationalist revolution, has been named President of the Chinese Nationalist Government.

* * *

County Counsel **Everett W. Mattoon** has announced the appointment of Deputy District Attorney **Robert Cushman** to fill the vacancy created by the resignation of Deputy County Counsel **Homer I. Mitchell**. Cushman is a graduate of the University of California and Harvard Law School.

* * *

The Council of the League of Nations and the Assembly of the League have elected **Charles E. Hughes**, ex-U.S. Secretary of State, to membership on the Permanent Court of International Justice to fill the unexpired term of **John Bassett Moore**, the American who resigned.

* * *

The first long distance flight of an autogyro, an entirely new form of air machine approaching the dream of a workable helicopter, was made when **Juan de la Cierva** flew his machine from London to Paris. It subsequently crashed at Le Bourget Field.

Los Angeles Bar Association

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YOUR TAX RETURN

(Continued from page 68)

from such subsequent sale over such cost basis. The fair market value of the property upon the date of the receipt thereof, therefore, becomes acutely important. The Bureau, in the interest of protecting the revenue, may contend for a high fair market value, while you, in the interest of paying only your just share of the taxes, may contend for a low fair market value. By the time a controversy may arise over such valuation, several, and sometimes many, years will have elapsed. You may have subsequently sold the property at a handsome price. Although hindsight should not control the outcome in such a controversy, human nature being what it is, it is unlikely that the handsome selling price will be ignored in resolving the issue. It is prudent then, whenever substantial transactions are involved, that you have the property appraised as of the time you received it by several disinterested and reliable appraisers. In the case of corporate stock, such stock may not have any fair market value upon the date of your receipt thereof, by reason of the presence of restrictions which destroy its fair market value. *Kuchman*, 18 TC 651. The restrictions need not be perpetual. It has been held that such expiration does not constitute or give rise to income. *Lehman*, 17 TC 652. In such event the entire proceeds from the ultimate sale might be a capital gain. The restrictions, however, and the expiration thereof, should be founded upon good business motives and should be real, so as to avoid a determination that the transaction is merely a sham or device resorted to for the purpose of converting ordinary income into capital gains.

(c) *Spreading Bunched Income Over the Taxable Years.*

You may at times find yourself working upon a case for many months, even years. Ultimately you may receive a substantial fee upon successfully concluding the matter, only to find that the bulk of your fee goes for taxes. IRC Section 107 affords some measure of relief in certain circumstances. When an appropriate case exists, you should by all means consult the statute in advance, for it spells out quite specifically the facts required to be present in order to qualify for the relief which it affords. Generally the services must cover a period of thirty-six calendar months or more, and at least 80% of your compensation from that matter must have been received in a single taxable year during the period

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of services. Note especially that if you qualify under the section, then you may spread your income over the period from the time that you commenced the services until the time that you receive such 80%. Accordingly, the relief contained in this section will not do you much good unless the date upon which you receive such 80% is remote from the date upon which you have commenced the services. Inasmuch as the section is a relief section, it becomes extremely important that you make and preserve careful records of your initial conferences and services thereafter rendered. For further interpretation of this section, see Reg. 39.107; P-H, Par. 7802; and CCH, Par. 684, *et seq.*

(d) Gratuities Received.

The question whether money or property received by you for legal services is a gratuity, is usually a factual one. When you have been engaged by a client under an agreement specifying your fee, and you have, at the conclusion of the matter billed him pursuant to such agreement, if he is perchance so delighted with the results that he not only pays your bill, but also an additional sum, the additional sum is probably a gratuity. *Warrick*, 44 BTA, 1068. This is, of course, a rare case. As a general rule, if you have rendered services to a client and thereafter you receive money or an article of appreciation, or have been permitted to purchase from the client property at a bargain, then you have received taxable compensation for services. P-H, Par. 7604; CCH, Par. 52,288.

C. DEDUCTIONS:

(a) Generally.

You are not entitled to any deductions unless you can point to a legislative enactment expressly authorizing the same.

IRC Sec. 23(a)(1) is the general provision allowing the deduction for professional expenses. It addresses itself to business expenses, salaries and rental expenses.

IRC Section 23(e)(1) authorizes the deduction for business losses. Reg. 39.23(a) deals more fully with these items. Section 39.23(a)-5 of the Regulations refers specifically to the expenses of a taxpayer engaged in a profession. It allows as a deduction the cost of supplies, expenses of operating and repairing an automobile used in the profession, dues to professional societies, and subscriptions to professional journals, rent paid for office rooms, the cost of fuel, light, water, telephone, etc., and the hire of office

assistants. It even allows as a deduction amounts currently expended for books, furniture and professional equipment, where the useful life of such items is short. Other items not specifically enumerated in the section of the Regulations referred to, however, are likewise deductible, and some of them will be discussed below.

(b) Salaries and Payroll Taxes.

While salaries are, of course, deductible, it is important to note that such salaries are deductible only to the extent that they are compensation for services already rendered. Even though you are on the cash basis, you are not entitled to a deduction for salaries paid for services to be rendered subsequent to the taxable year. In such event it is likely that you will lose the deduction altogether, for in the subsequent taxable year, when the services which you have already paid for are being rendered, no payment is then being made by you giving rise to any deduction.

In connection with the several payroll taxes which you pay to the Federal and state governments quarterly, your remittances contain two parts: One part consists of your deductible business expense, namely, your share of such taxes, and other consists of a portion of the salaries of your employees which you, acting as a collector, have withheld from such salaries and are forwarding to the taxing authorities.

A question sometimes arises as to whether a person receiving compensation from you for services is an independent contractor and, therefore, not subject to the payroll taxes, or is an employee and, therefore, subject. In a lawyer's office the question most often arises in connection with part-time stenographers. The usual rules regarding master and servant are not necessarily applicable. *U.S. vs. Silk*, 331 U.S. 704; *Bartels vs. Birmingham*, 332 U.S. 126. Most often such part-time persons are employees, and not independent contractors.

(c) Depreciation.

When a taxpayer purchases for use in his business certain assets, for example, books, furniture or professional equipment having a useful life which is greater than one year, then the price paid for such an asset constitutes a capital expenditure and not an expense. Accordingly, the expenditure is not deductible. But if the value of such an asset depreciates by reason of wear and tear through such use, or by reason of the fact that it becomes outmoded or, as in the case of leasehold improvements, by the

expiration of a legal or contractual right, then the item involved has in fact been consumed in the conduct of the taxpayer's business. This consumption has occurred gradually and over the years and the taxpayer may take a deduction for such consumption, but in a corresponding manner, namely, gradually over such years.

IRC Section 23(1) allows the taxpayer a depreciation deduction by reason of such consumption or exhaustion.

Where you have purchased the depreciable asset, then the amount to be depreciated is your cost, less the salvage value. Technically, the amount to be depreciated is your adjusted basis as set forth in IRC Section 113(b). If you have acquired the depreciable property through any transaction other than a purchase, then it is suggested that you refer first to Section 113(a) for your basis and then to IRC Section 113(b) for your adjusted basis. The amount to be depreciated must be spread over the estimated life of the asset, usually, uniformly and ratably over such life, unless you are prepared to substantiate some other method. After you have thus recovered the cost of the asset down to its scrap value, you are no longer entitled to depreciate the same. Reg. 39.23(1)-4 and -5. You cannot pass up the depreciation in a low year and catch up in a high year. Reg. 39.23(1)-5. The Bureau has issued Bulletin F, which contains a rather complete discussion on the subject of depreciation. P-H, Par. 14,160 and CCH, Par. 219.27. This bulletin furnishes the Bureau's recommended rates for various specific items of business assets, and according to the use of such assets in various specific businesses. For judicial determinations of allowable depreciation rates in controversies between the taxpayer and the Bureau, see P-H, Par. 14,159 and CCH, Par. 219.50 *et seq.*

Bulletin F authorizes the taxpayer to segregate depreciable assets into class groups where use is the guiding factor in the selection. Only items similar in kind and having the same average useful life should be grouped into one account.

As a general rule law offices group the depreciable assets into the following categories, namely, (1) office furniture, fixtures and equipment, (2) library, and (3) interior decorations.

Although the rates hereinafter mentioned may vary by reason of special factors which the taxpayer may be in a position to establish, or by reason of determination made by a Revenue Agent

upon an audit, the rates usually prevailing are as follows, namely, for office furniture, fixtures and equipment, a depreciation rate of 10% per year, for library 10% per year, for interior decorations from 10% to 20% per year.

Leasehold improvements, having a useful life which exceeds the remainder of the term of the lease at the time such improvements are installed, may be depreciated over the portion of the lease term then remaining. If the lease is renewable by the tenant, the renewal option may be ignored unless the relevant facts show with reasonable certainty that the renewal option will be exercised. In such event, the renewal period must be taken into account. 39.23(a)-10.

(d) Repairs.

Repairs to property used in the attorney's profession are deductible. All work done, however, on such property may not constitute repairs. If the work done materially adds to the value of the property or prolongs its life appreciably, then the cost of such work is a capital expenditure and, if the asset involved is a depreciable asset, then the capital expenditure is recoverable by way of additional depreciation to be taken over the then remaining useful life of the

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property. Reg. 39.23(a)-4. For example, a new roof is a capital expenditure, but repainting is usually a repair. If, however, you make repairs and improvements at the same time, then a problem may arise, for the Bureau may then contend that a great deal of work done and ordinarily regarded as repairs if done alone, should be treated as improvements. In such a case, even the repainting might be considered improvements by the Bureau. P-H, Par. 12, 313; CCH, Par. 155.08. Where, however, you must make repairs and improvements at the same time, for example, renovating a building owned by you so that you can occupy the same for conducting your practice therein, then it is suggested that you have your architect and general contractor each furnish you with statements specifying what are repairs and what are improvements.

(e) Rents.

While you ordinarily deduct, if on the cash basis, rents when you pay them, and, on the accrual basis, when the rent accrues, in the event that you have paid rent for future years or for months in future taxable years, you may only deduct rents applicable to such future months or years when those future years arrive, even though on the cash basis. P-H, Par. 12,015; CCH, Par. 409.624.

(f) Use of Home for Business Purposes.

Congress has specifically allowed certain personal expenses as deductions. No such deductions, however, are allowed with respect to a taxpayer's personal dwelling used as such. This would, of course, apply to repairs, depreciation, heat, light, maid service, or, in the case of rented accommodations, the rents. Real estate taxes and interest on the mortgage are, however, allowable as deductions by reason of specific provisions of the law allowing taxes and interest as deductions, irrespective of whether or not such expenses are personal or business.

Many lawyers conduct a certain amount of their business at home, such as conferences with clients, telephone conferences, research, drafting, correspondence, and entertaining for business reasons. If you thus use your home, all the expenses directly attributable to such business activities, such as long distance telephone calls, caterers, extra servants, filing cabinets, shelves, a separate telephone devoted exclusively to business use, professional literature, library depreciation, and typewriter depreciation are deductible. As to the indirect expenses, for example, heat, light, maid serv-

ice and repairs, you are entitled to make a fair allocation as between personal and business use. Where a room is set apart exclusively for such work, then with respect to some of these expenses, allocation may be made upon the basis of relative areas. You may be called upon by the Bureau to substantiate the fact that you thus use your home for business purposes. Such substantiation is best accomplished by setting apart some room in your dwelling exclusively for business use and by installing in such room the equipment, furniture and other items ordinarily used by you in doing such work. It might even be desirable to keep records to be able to show an Agent, if he raises a question, what work you have been doing at your home.

(g) Entertaining for Business Purposes.

The expenses of entertaining for business purposes are deductible, P-H, Par. 11,300 and CCH, Par. 146.2664 *et seq.*, whether such entertaining be done at home or away from home. Technically, you have the right to estimate such expenses. *Cohan vs. Commissioner*, 2nd Cir., 39 Fed.(2d) 540. Actually, however, the subject is susceptible to abuse. Accordingly, an estimate standing alone will not fare so well, for, upon an audit a Revenue Agent may sharply reduce your estimate. To substantiate your deduction, then, you should keep a record of your business entertaining in a diary, showing dates and persons entertained, the nature or place of entertaining and the amounts expended. Even then, an Agent will sometime call upon you to go further and show which of the persons entertained are your clients or have become your clients. He may be influenced in his action to some extent by the connection you are able to show in that respect. While it would seem that the tax laws do not require that a business expense be successful, nevertheless, an attorney was denied a deduction for entertainment expenses upon failing to prove that his business benefited from such activity. *Lorenz*, Tax Court, 1949 Memorandum Decision.

(h) Business Gratuities.

Gifts made by you for business reasons are deductible so long as they are ordinary and necessary. *Goodrich*, 20 TC....., 141.

(i) Use of Personal Car for Business Purposes.

Usually your car is used both for personal and business purposes. Driving to and from home and office is personal use, not business.

Where you thus use your car for both personal and business reasons, the expenses thereof, including depreciation, maintenance, repairs, operation, licenses, interest, insurance and property tax, may be allocated between the two uses upon a fair and reasonable basis. CCH, Pars. 144A .058 and 153.036 *et seq.* The portion of such expenses allocable to personal use is not deductible, except for those items as are specifically allowed by law as personal deductions, for example, licenses, interest, taxes, gasoline tax and sales tax.

(j) Travelling Expenses.

Expenses of travelling while away from home in the pursuit of business, including meals and lodging, are deductible. While the Bureau has usually regarded the attendance at Bar conventions as being in the pursuit of business, it has usually contended that attendance at meetings or institutes intended to disseminate knowledge in special fields, for example, taxes, labor law, or patents, does not constitute the pursuit of business, but is a personal pursuit, namely, education. It has recently been held, however, that attendance at a tax institute by a practicing attorney constitutes the pursuit of business. *Coughlin vs. Commr.*, 2nd Circuit; 203 Fed. (2d) 307. In view of the fact that the court concluded that when an attorney attends a tax institute he is, in fact, sharpening his tools, it is most likely that the holding in the *Coughlin* case will be extended in the case of practicing attorneys to attendance at many meetings or institutes heretofore regarded as educational, for example, continued education programs.

(k) Tuition Fees for Attending Institutes and Continued Education Programs.

Such tuition fees should be treated in the same manner as the travelling expenses incident to attending such programs. Under the sharpening of tools test, any tuition is deductible.

(l) Expenses of Admission to Bar.

These are not deductible, for the reason that the candidate is not then engaged in any business and, as a consequence, such expenses are personal.

(m) Division of Fees.

The share of any fees paid by you to an associate or colleague are deductible, provided you include the entire fee in your income when received by you. *Horblit*, 1943 Tax Court Memorandum Decision.

ever, provides for special treatment of such property if it has been held for more than six months. Under certain circumstances the gain from such sales are taxed, not as ordinary gains, but as capital gains. To determine whether or not you are entitled to the benefit of Section 117(j), you must first compute the net result of (1) all sales during the year made by you of such property, and (2) of all involuntary dispositions or conversions of any property held by you for more than six months where such involuntary dispositions or conversions result from destruction, theft, seizure or condemnation. If the net result of all such transactions is a loss, then you ignore Section 117(j) and report each gain or loss separately. If, on the other hand the net result is a gain, then you are entitled to report such gain as capital gain. If you have several Section 117(j) assets, and you expect to sustain losses on some and gains on others, you can minimize your taxes by selling the loss items in one year and the gain items in another.

(b) Exchanges.

If you trade in depreciable property, originally acquired by you through purchase and used in your business, for new property of like kind, receiving a credit against the price for the property traded in, the balance of the price of the new property to be paid by you in cash, or by way of deferred payments (for example, a typewriter for a typewriter, or a desk for a desk), ordinarily, if the credit thus allowed you exceeds your adjusted cost (original cost less depreciation), the excess of such allowance over such adjusted cost would be a taxable gain. Under IRC Section 112(b) (2), however, the transaction is tax-free. You simply treat as the cost of the new asset the adjusted cost of the old asset plus the cash being additionally paid.

If substantial assets are involved, for example, your office building, or business automobile or costly equipment, you may not want a tax-free exchange. This might be especially so if a loss must be sustained on the old asset, for you will probably be better off selling the old asset at a loss, taking a full deduction for such loss against ordinary income and then depreciating the full price of the new asset over its useful life. Similarly, where a gain is being realized on the old asset held for more than six months, you may prefer to sell the old asset instead of exchanging it in a trade-in, for you can, by selling the old asset, report the gain as a long-term capital gain,

and then depreciate the purchase price of the new asset over its useful life, getting the benefit of the depreciation deductions on the new asset against ordinary income. In a gain case, however, if you sell instead of trade, you will have to pay the capital gain tax now and, if the newly acquired asset has a long useful lifetime, it may take a long time before you will be coming out ahead. This will depend on what tax bracket you will be in over the years.

E. PERSONAL DEDUCTIONS VS. BUSINESS DEDUCTIONS:

It has been noted hereinabove that certain specific expenses are deductible, whether or not they constitute business expenses, for example, interest and taxes. Yet, in discussing allocation of expenses as between the use of your home for personal purposes and for business purposes, and as well in allocating the expenses of operating and maintaining an automobile used for personal purposes as well as business purposes, it has been suggested that the several deductible expenses, including any such interest and taxes be allocated as between the two uses. You may wonder why such allocation is necessary in the case of personal expenses which are deductible in all events. Firstly, it is probably imperative to do so to correctly compute adjusted gross income, since adjusted gross

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income constitutes the basis in determining the percentage limitation on the deduction for charitable contributions and medical expenses. Secondly, such allocation minimizes your personal deductions, and in making such allocations you may find your personal deductions reduced to such an extent that it becomes an advantage to you to then take the standard deduction in lieu of your personal deductions.

IRREVOCABLE TRUSTS

(Continued from page 71)

cient standard; care and comfort would not be. These rules apply whether the grantor is trustee or the trustee is a relative or employee. This power, not limited by external standards, may safely be given to a corporate trustee. (See A.4, *supra*.)

5. The power to invade corpus for the benefit of the life beneficiary.

6. The power to accumulate income for a beneficiary who will receive it and the corpus upon attaining a definite age or other event which may be reasonably expected to occur within the beneficiary's lifetime, but see A.3, *supra*.

Professor John W. Ervin, of the U.S.C. Law School, from whose summary of the Clifford Regulations (in the panel discussion of June 15, 1950, held under the auspices of Title Insurance & Trust Company) I have borrowed in preparing the foregoing, states:

"If a client asks you to create a trust in which his wife and children are beneficiaries, try to discourage him from being trustee. If he wants his wife, brother or sister, father or mother, or any employee to be trustee, try to discourage him because the Clifford Regulations are aimed at economic and family control. They tax the income to the grantor if he is in a position to control the beneficial enjoyment of the trust income or corpus either directly as trustee or indirectly through family or economic control of the trustee. If the trustee is not related by family or business to the grantor, the danger of the regulations is greatly diminished."

II. *Where the Grantor has a Reversionary Interest After a Short Period*²

Income of a trust is taxable to the grantor where he has a reversionary interest in the corpus or income therefrom which will,

²Material under this Sec. II and the following Sec. III is an abridgement of the discussion by Mr. Arthur Manella, attorney and tax counselor, which took place at the aforesaid panel discussion. Professor Ervin's and Mr. Manella's contributions are available in printed form.

or may reasonably be expected to, take effect in possession or enjoyment—

A. Within ten years after the transfer,³ or

B. After ten years but within fifteen years of the transfer if—

1. The income is or may be payable to a beneficiary other than a charity, and

2. Any of the following powers of administration over the corpus or income is exercisable, whether or not as trustee, by the grantor, or spouse (living with grantor and not having a substantial adverse interest in the corpus or income) or both:

(a) A power to vote or direct the voting of stock or other securities;

(b) A power to control the investment of trust funds, either by directing investments or reinvestments or by vetoing proposed investments or reinvestments;

(c) A power to reacquire the trust corpus by substituting other property, whether or not of an equivalent value.

Comments:

(a) Where the grantor's reversionary interest is to take effect by reason of some event other than the expiration of a specific number of years, the trust income is taxable to him if such event is the practical equivalent of less than ten or fifteen years, as the case may be. Cases arising under this provision must be considered as they come up in the light of the detailed provisions of the Regulations.

(b) Where the grantor's reversionary interest is to take effect within ten or fifteen years, as the case may be, but only if the grantor survives a stated contingency, the trust income is taxable to him if the stated contingency is of an insubstantial character. Cases arising under this situation should also receive consideration when and if they come up.

III. *Administrative Control*

Regardless of the duration of a trust, the income is taxable to the grantor where administrative control is exercisable primarily for his benefit rather than for the benefit of beneficiaries, either under the terms of the trust or the circumstances attendant upon

³The Clifford Regulations were held unconstitutional, at least as to the 10 year period, in *Com. v. Clark*, 202 Fed. 2d 94; 66 Harv. L. Rev. 1532, note.

its operation. Administrative control is exercisable primarily for the benefit of the grantor where:

(a) There is a power exercisable (whether or not as trustee), by the grantor or any person not having a substantial adverse interest, which enables the grantor or any person to purchase, exchange or otherwise deal with or dispose of the corpus or income for less than an adequate consideration; or

(b) There is a power exercisable (whether or not as trustee) by the grantor or any person not having a substantial adverse interest, which enables the grantor to borrow the corpus or income either (1) without adequate interest or (2) without adequate security. If the trustee is a corporation and is authorized under the general lending power of the trust to make loans without security to outsiders, the grantor is not taxable on income because such loans can be made to him; or

(c) The grantor has borrowed the corpus or income and has not completely repaid the loan before the beginning of the taxable year; or

(d) Any one of the following powers over the trust income or corpus is exercisable in a *non-fiduciary capacity* by the grantor, or any person not having a substantial adverse interest:

1. A power to vote or direct the voting of securities;
2. A power to control investments either by direction or veto;
3. A power to reacquire the corpus on substituting other property of equal value;

(Note, under (d) it seems that where a corporation is trustee, an independent consultant may be given power to direct or veto investments without causing the income to be taxable to the grantor. If the trust corpus contains stock in a closely held corporation it may be difficult to determine whether a consultant's power to direct voting is held in a fiduciary capacity.)

IV. *Where Trust Income is used for Support of Family*

Section 167(c) I.R.C. provides that the income of an irrevocable trust is not taxable to the trustor merely because such income, in the discretion of another person, the trustee, or the trustor acting as trustee, may be applied or distributed for the support or mainte-

nance of a beneficiary whom the trustor is legally obligated to support or maintain, except to the extent that such income is so used.

As above mentioned, income not taxable to the trustor under Sec. 167(c) because not distributed, may, nevertheless, be taxable to him under the Clifford Doctrine discussed under I, II, and III, above.

Similarly, apart from the Clifford rule, the trustor is taxable on the income of a trust which directs that it be paid or applied to satisfy the trustor's legal obligations. Note that in a tax case items which are beyond mere necessities may be held to fall within the obligation of support, for example, a college education.⁴

Suppose a trust directs that the income be paid to a minor child, that the child is under guardianship, and that the income is paid to the guardian. It seems doubtful whether such income is taxable to the trustor (unless the trust is so drawn as to be subject to the Clifford rule) since the guardian could not ordinarily use the income to support and maintain the child, in view of Sec. 196 Civil Code and Sec. 1504 Probate Code. If the minor has no guardian, with the result that the trustee is unable to pay out the income, the result may be less certain. The numerous uncertainties surrounding this and other aspects of the topic under discussion are well brought out in an article by Mayo Shattuck, entitled "Gifts to Minors" published in *Trusts and Estate* for October, 1953, page 659.

In the foregoing connection, note that if a minor child's total annual income is less than \$600.00, the minor need file no return; furthermore, the parent does not lose the \$600.00 exemption for said minor.⁵ (This does not apply where the parent furnishes less than half of the minor's support.) If the child's income from all sources exceeds \$600.00, the parent loses the \$600.00 exemption for said child.

Since property placed in a trust of the type which we are discussing cannot be expected to obtain a new tax basis on the trustor's death, it is generally wise to place property with a high income tax basis in the trust. Its eventual sale will then result in a smaller tax.

⁴*Helfrich v. Com.*, 143 Fed. 2d 43.

⁵Sec. 25(b) I.R.C.

